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# Inheritance Tax--Is Federal Estate Tax Paid Totally Deductible

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## STUDENTS NOTES

# INHERITANCE TAX — IS FEDERAL ESTATE TAX PAID TOTALLY DEDUCTIBLE?\*

The fact that certain United States Government bonds are sold at a discount and can be surrendered at par in the payment of federal estate tax has created a problem recently in the computation of the West Virginia inheritance tax;<sup>1</sup> a problem which the West Virginia Supreme Court of Appeals thus far has declined to review.<sup>2</sup> In several instances the State Tax Commissioner has disallowed as a West Virginia inheritance tax deduction a portion of the federal estate tax paid; and in all instances the trial court has ruled in favor of the taxpayer.<sup>3</sup> The results of such disallowance have been to cause additional litigation expenses, and to delay the distribution of an estate.

The controversy evolves from whether the full amount of federal estate tax paid is deductible for inheritance tax purposes where United States Government bonds are valued differently for federal tax purposes than they are for inheritance tax purposes.

Apparently as one method by which to refund the national debt,<sup>4</sup> the Internal Revenue Code authorizes the Secretary of the

\*The writer wishes to express appreciation to the law firm of Schmidt, Laas, Schrader & Miller of Wheeling, West Virginia for their cooperation in researching this topic. This firm has had the occasion to litigate this question in three cases in Ohio County, West Virginia.

<sup>1</sup>*In re Aul*, No. 4566-M (Ohio County Cir. Ct., W.Va., 1969); *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W.Va., 1968); *In re Camden*, No. 9412 (Wood County Cir. Ct., W.Va., 1968); *In re Laupp*, No. 2805-M (Ohio County Cir. Ct. W.Va. 1967).

<sup>2</sup>On April 28, 1969 the West Virginia Supreme Court of Appeals refused the appeal of the West Virginia State Tax Commissioner in the case of *In re Bowers*. No. 4146-M (Ohio County Cir. Ct., W. Va. 1968). This writer has been advised that the Tax Commissioner has appealed the adverse decision rendered in the case of *In re Aul*, No. 4566-M (Ohio County Cir. Ct., W.Va. 1969).

<sup>3</sup>The taxpayer has prevailed in all cases cited in note 1 *supra* except the case of *In re Camden*. No. 9412 (Wood County Cir. Ct., W. Va., 1968). The apparent reason was that the Treasury bonds in question were appraised in the West Virginia inheritance tax return at their par value rather than at their market value, as they were in the other cases cited in note 1.

<sup>4</sup>It appears that by accepting the United States Treasury bonds at par value, the United States Government gains the advantage of being relieved of its outstanding indebtedness and the interest liability on the bonds.

Treasury to receive at par, plus accrued interest, designated issues of United States' obligations for the payment of internal revenue taxes.<sup>5</sup> The Secretary has designated certain United States Treasury bonds which may be used to pay estate taxes.<sup>6</sup> Accordingly, "eligible" bonds may be surrendered to the Treasury Department at par at any time before their maturity date to apply against the federal estate tax due from an estate.<sup>7</sup> That is, these "eligible" bonds may be surrendered at par as a credit against the estate tax liability regardless of their market value. The advantages to the estate of redeeming "eligible" bonds are that they provide liquid assets with which to pay the tax and they can save the estate money.<sup>8</sup> However, federal requirements are that "eligible" bonds owned by a decedent at death are to be included in the gross estate at par, or their market value, whichever is higher to the extent that the bonds may be used to pay the federal estate tax.<sup>9</sup> Further, bonds in excess of the amount which may be applied to pay estate taxes are includible in the gross estate at their market value at the date of death.<sup>10</sup> There is no requirement that the bonds must be surrendered to pay the tax, but only that they be valued at par, to the extent of the federal estate tax liability.

The problem with the West Virginia inheritance tax arises after the estate tax has been computed and the fiduciary claims a full deduction for the federal estate tax paid. The State Tax Commissioner has refused to allow the full amount of the federal estate tax paid, claiming, in effect, that the assets of the estate were not

<sup>5</sup>INT. REV. CODE of 1954, § 6312.

<sup>6</sup>Treas. Reg. § 301.6412-2 (1954). For a list of Treasury bonds eligible for redemption at par to pay Federal Estate Tax see 1 CCH FED. EST. & GIFT TAX REP. ¶ 4220.45 (1966).

<sup>7</sup>Tres. Reg. § 301.6312 (1954). For a discussion of this section see 1 CCH FED. EST. & GIFT TAX REP. ¶ 4220.08 (1969).

<sup>8</sup>1 CCH FED. & GIFT TAX REP. ¶ 4220.077 (1969) states:

[F] or example, assume a decedent owned a \$1000 3¼% bond that was purchased for and has a current market value of \$860. His estate is in the 25% tax bracket. By using the bonds to pay taxes, the estate will realize a net savings off \$105. The bond purchased for \$880 can be redeemed at its par value of \$1000, thus saving \$140 in cash. (The estate does not have to pay income taxes on the \$140) However, bonds used in the payment of taxes must be valued at their par value. The decedent's estate therefore, is increased \$140, thus increasing its tax liability by \$35 (\$140 x 25% = \$35); thereby saving \$105.

<sup>9</sup>Rev. Rul. 156, 1953-2 CUM. BULL. 253; *Chandler v. United States*, 303 F.2d 439 (5th Cir. 1962); *Bankers Trust Co. v. United States*, 284 F.2d 537 (2nd Cir. 1960).

<sup>10</sup>Rev. Rul. 156, 1953-2 CUM. BULL. 253; *Bankers Trust Co. v. United States*, 284 F.2d 537 (2nd Cir. 1960).

properly valued.<sup>11</sup> The Commissioner's reason is that the bonds were valued in the inheritance tax return at market value whereas they should have been included at par value, as they were in the federal estate tax return.<sup>12</sup>

An example may illustrate the problem which has been occurring in West Virginia. Suppose among the assets of an estate are United States Treasury bonds which are eligible for redemption at par as a credit against the federal estate tax. These bonds have a par value of \$25,000, but a market value at date of death of only \$21,000. The federal estate tax liability is determined to be in excess of \$25,000. The fiduciary has the option to surrender these bonds to the United States Treasury Department and receive a credit of \$25,000 (plus accrued interest) against the federal estate tax. These bonds are required to be included in the federal estate tax return at \$25,000. However, these same bonds are included in the West Virginia inheritance tax return at market value of \$21,000 and West Virginia inheritance tax is computed with the bonds at this value. The State Tax Commissioner then reduces the deduction for Federal Estate Tax paid by the difference of \$4,000 between market value and par value of the bonds.<sup>13</sup> The commissioner then assesses a deficiency claiming an additional tax due upon this \$4,000 on the theory that these bonds should have been included at par value and not at their market value in the West Virginia inheritance tax return.

The full amount of federal estate tax paid is normally a deduction in computing the West Virginia inheritance tax. The West Virginia Supreme Court of Appeals resolved the question of deductibility of federal estate tax in *Central Trust Co. v. James* in which it was stated in the court's syllabus, "In determining the base for the application of the inheritance tax rates . . . there should be deducted, *inter alia*, from the value of the property involved, the

<sup>11</sup>Brief for Commissioner, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W. Va. 1968). It is noted that the Tax Commissioner filed the same brief in the case of *In re Aul*, No. 4566-M (Ohio County Cir. Ct. W.Va., 1969), except for the variations in the value of the bonds.

<sup>12</sup>Brief for Commissioner, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W.Va. 1968).

<sup>13</sup>*Id.* The Tax Commissioner is erroneous in approaching the deduction in this manner. In reducing the deduction for Federal estate tax paid by the difference between market value and par value, the Tax Commissioner is in effect increasing the amount includible on the West Virginia inheritance tax return on account of the bonds by this amount. If the Commissioner were to reduce the deduction for the federal estate tax properly, he should limit that deduction to the amount of federal estate tax attributable to the difference between the bonds' par and market values.

amount of the transmission tax, sometimes called estate tax, levied and collected by the Federal Government."<sup>14</sup> In another case, the court pointed out that West Virginia inheritance tax statute authorizes payment "of debts due the United States" and also authorizes the payment of "taxes" without any restrictions as to the type of tax or how it is to be assessed in advance of the determination of other claims.<sup>15</sup> Further, the court said "[W]hether . . . the federal estate tax be considered a 'debt', a 'claim', or an 'administrative expense', the result is the same. It must . . . be deducted from the whole personal estate of inheritance . . . ."<sup>16</sup> Therefore, from these authorities it would appear that the question of deductibility of the total federal estate tax actually paid has been judicially passed upon in West Virginia.

However, the State Tax Commissioner has taken the position that the rule of deductibility of the full federal estate tax paid applies only where the United States Treasury bonds are valued the same for both federal estate tax and West Virginia inheritance tax purposes, that is, at par value.<sup>17</sup>

The section of the West Virginia Code which forms the basis for the Commissioner's disallowance states "[M]arket value of property is its actual market value after deducting debts and encumbrances for which the same is liable, *and to the payment of which it shall actually be subjected* . . . ."<sup>18</sup> The Commissioner's reasoning is that since the government bonds are includible at par for federal estate tax purposes, they should be includible at par for inheritance tax purposes. Otherwise, contends the Tax Commissioner, property is passing from an estate to beneficiaries without first having been subjected to the West Virginia inheritance tax.<sup>19</sup> The argument is that the bonds should be included for West Virginia tax purposes at par because they have a value to the estate of that amount when they are used to pay the federal taxes. Further, the Commissioner

<sup>14</sup>120 W.Va. 611, 199 S.E. 881 (1938).

<sup>15</sup>Guaranty National Bank v. Mitchell, 144 W.Va. 828, 833, 111 S.E. 2d 494, 497 (1959).

<sup>16</sup>*Id.* at 833, 111 S.E.2d at 497.

<sup>17</sup>Brief for Commissioner at 12, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W.Va. 1968), where it states "[W]e would add, however, if the bonds in question had been properly appraised at their true market value, to wit: \$25,000 (this was their par value) the full deduction . . . would have been allowed."

<sup>18</sup>W.Va. CODE ch. 11, art. 11, § 5 (Michie 1966) (emphasis added).

<sup>19</sup>Brief for Commissioner at 11, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W.Va., 1968).

claims that the assets passing to the beneficiaries are under the taxpayer's treatment being subjected to an inheritance tax based only upon the market value of the bonds while the par value is used by the taxpayer for purposes of determining the federal estate tax paid deduction.<sup>20</sup> Thus in the previously given example the Commissioner would claim that the bonds are only subjected to a tax upon \$21,000 and the estate is claiming a deduction for a tax based upon assets valued at \$25,000.

The Tax Commissioner's first line of attack upon the deductibility of the full amount of federal estate tax paid is that beneficiaries are receiving property which has not been first subjected to an inheritance tax. The Commissioner's theory is that the "credit" of the increment value (\$4,000 in the above example) which the estate is receiving in payment of the Federal Estate Tax liability enhances the value of the property in the estate.<sup>21</sup> Therefore, this increment value should be subjected to the inheritance tax; and if it is not, then property is being transferred tax-free.<sup>22</sup>

This argument seems erroneous for several reasons. First, the Tax Commissioner is attempting to tax an artificial value rather than the property itself. The assessment of the additional tax upon the difference between market value and par value of these bonds imposes a tax upon property *not* received by a beneficiary. The fiduciary is not required to surrender the bonds and receive a "credit" against the federal estate tax; he is *only* required to include the bonds at par to the extent they *may* be used to satisfy estate tax liability.<sup>23</sup> He may properly elect not to surrender the bonds but distribute them to beneficiaries.

The intent of the West Virginia inheritance tax laws is to place a tax only upon property which is *actually* received. The theory of the inheritance tax is that it taxes the right to receive property, not the right to transmit property.<sup>24</sup> The court in *Central Trust Co. v. James* declared that "[I]n enacting the West Virginia inheritance tax statute, the Legislature obviously had in mind to place an ex-

<sup>20</sup>*Id.* at 8.

<sup>21</sup>Brief for Commissioner, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W. Va., 1968).

<sup>22</sup>*Id.*

<sup>23</sup>Rev. Rul. 156, 1953-2 CUM. BULL. 253; *Bankers Trust Co. v. United States*, 284 F.2d 537 (2nd Cir. 1960).

<sup>24</sup>*Kanawha Banking and Trust Co. v. Alderson*, 129 W. Va. 510, 40 S.E.2d 881 (1946).

cise on property received by inheritance . . . . The statute clearly manifests and intends *not to impose a tax on any portion of property not received* . . . ."<sup>25</sup> Therefore, it is arguable that the Tax Commissioner by assessing a deficiency is violating legislative intent by attempting to tax property not received by a beneficiary. In the previously given example, the beneficiary was not receiving property which had an actual value of \$25,000, but instead property worth only \$21,000, the market value of the bonds on date of death. If the beneficiary wished to sell these \$25,000 face value bonds on the open market, he would receive only what their market value was on the date of sale; he could not sell the bonds for par value. Obviously, he did not receive property worth par value but property worth only its market value. The mere fact that the United States Government would accept these bonds at par value does not change the *value* of the property received by the beneficiary.

Secondly, by disallowing a portion of the federal estate tax paid, the Tax Commissioner also appears to ignore his own regulations. In the regulations it is stated that "Where a decedent dies a resident of West Virginia, a deduction is allowed for Federal Estate Tax paid in determining the inheritance tax. The amount of the Federal Estate Tax deductible . . . is the amount actually paid or payable, *without regard to the valuation* of such property for Federal Estate Tax purposes."<sup>26</sup> The example given in the regulation<sup>27</sup> concerns a situation where the fair market value of a decedent's assets subject to both estate tax and inheritance tax on the date of death was \$100,000. However, on the alternate valuation date, as authorized by the Internal Revenue Code for estate tax purposes, the value of the assets was \$75,000. The alternate valuation was elected by the executor and the estate tax amounted to \$2,000. The example states that only \$2,000 will be allowed as a deduction in determining the value of the property subject to the inheritance tax. However, suppose this situation were reversed and the value of the assets was \$75,000 on date of death, but on the

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<sup>25</sup>Central Trust Co. v. James, 120 W. Va. 611, 614, 199 S.E. 881, 882 (1938) (emphasis added). However, the Commissioner may argue that net economic effect of the allowance of payment at par is that receipt by the estate beneficiary of an increased amount equivalent to the difference between par and market value, thereby increasing the beneficiary's net inheritance.

<sup>26</sup>W.Va. Ad. Reg. 11-11 § VI (2.04) (emphasis added).

<sup>27</sup>*Id.*

<sup>28</sup>INT. REV. CODE OF 1954, § 2033.

alternate valuation date the value was \$100,000. The fiduciary then elected to pay a tax based upon the higher valuation,<sup>29</sup> and thereby paid a higher amount of federal estate tax. Would the Tax Commissioner then refuse to follow the regulation and not allow the full deduction for the higher federal estate tax paid? It would seem illogical to use a standard of estate tax actually paid in the former situation and refuse to use it in the latter. By analogy the fact that the federal government permits a taxpayer to use bonds at par in the payment of taxes should have no effect on the computation of the West Virginia inheritance tax deduction for federal estate tax paid.<sup>30</sup>

The Tax Commissioner contends alternatively that the government bonds are includible in the inheritance tax gross estate at par because this is the market value of the bonds.<sup>31</sup> As authority for this contention he relies upon a definition of market value, by the West Virginia Supreme Court of Appeals:<sup>32</sup>

Market value may be established, under proper conditions of time and place, by the price at which a seller who is willing to sell, and a buyer who is willing to buy, effect a sale of property when both act voluntarily and without compulsion.

The Commissioner takes the view that since the Secretary of the Treasury is authorized to redeem these bonds at par there is a willing buyer. And, since the fiduciary normally will surrender these bonds to obtain the tax advantages there is a willing seller, thus establishing market value at par.<sup>33</sup> Further, it is the Tax Commissioner's position that since the fiduciary will readily use these bonds to pay the estate tax there is no question concerning compulsion.<sup>34</sup>

<sup>29</sup>At times it may be advantageous to elect the higher valuation in order that the assets will get a stepped up cost basis for income tax purposes. For example, a stock may have a market value of \$70 on the date of death, and a market value of \$100 on the alternate valuation date. The fiduciary may properly elect to accept the higher value so the cost basis to the beneficiary is \$100. Thereafter, the capital gains tax to the beneficiary will be lower when he sells the stock. INT. REV. CODE OF 1954 § 1014, § 2032.

<sup>30</sup>Memorandum opinion of the Honorable James G. McClure in the case of *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W. Va., 1968).

<sup>31</sup>Brief for Commissioner, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W. Va., 1968).

<sup>32</sup>*Franklin v. Pence*, 128 W. Va. 353, 361, 36 S.E.2d 505, 510 (1945).

<sup>33</sup>Brief for Commissioner at 19, 20, *In re Bowers*, No. 4146-M (Ohio County Cir. Ct., W. Va., 1968).

<sup>34</sup>*Id.*



In other words, the Commissioner is simply saying that since there is a single buyer who is willing to buy at par value, this establishes the price at which the bonds are includible in the West Virginia inheritance tax return.

The contention advanced by the Tax Commissioner cannot be supported by the mandatory definition of market value in West Virginia. The West Virginia Code states that "market value of property is its *actual market value* after deducting debts and encumbrances . . . ."<sup>35</sup> In defining market value in *Franklin v. Pence*<sup>36</sup> the court seemingly established that the West Virginia inheritance tax is to be computed upon market value as of the date of death. The market value of property is that price agreed upon by a willing buyer and a willing seller dealing in an arm's length transaction without compulsion.<sup>37</sup> Therefore, it seems erroneous to conclude that market value is the par value simply because the United States Government is willing to pay that price. The fact that federal regulations require these bonds to be included at par for estate tax purposes should not be sufficient reason to contend that such regulation established the market value at par. Market value is set in the market place.

Further, the Commissioner's view that the parties are dealing freely is subject to question. The fiduciary is under compulsion due to the Treasury Department's *requirement* that "eligible" bonds be included at par, and if the fiduciary elects to surrender the bonds, they will be accepted at par to the extent they may be used to pay the estate tax.<sup>38</sup> Granted, the fiduciary is not required to surrender the bonds in payment of the tax, but failure to do so might subject him to severe criticism and possibly damages for breach of his fiduciary duty. Therefore, since the fiduciary is under compulsion, this compulsion is in direct conflict with the definition of market value in West Virginia.

In conclusion, by taking the position that he has the authority to refuse to allow less than 100 per cent deduction for federal estate taxes paid, the Commissioner appears to be in conflict with the legislative intent, case and statutory law, and the West Virginia in-

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<sup>35</sup>W.VA. CODE ch. 11, art. 11, § 5 (Michie 1966) (emphasis added).

<sup>36</sup>*Franklin v. Pence*, 128 W.Va. 353, 361, 36 S.E.2d 505, 510 (1945);

<sup>37</sup>See *Franklin v. Pence*, 128 W. Va. 353, 361, 36 S.E.2d 505, 510 (1945); Treas. Reg. § 202031.

<sup>38</sup>Rev. Rul. 156, 1953-2 CUM. BULL. 253; *Bankers Trust Co. v. United States*, 284 F.2d 537 (2nd Cir. 1960).